# Moscow Financial Weekly

For the Week Ending September 28, 2001

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**Highlights This Week**

- Budget passes the first reading
- Joint Banking Strategy: no watershed
- **Weekly Focus**: Civil Service Reform

**Key Economic Indicators**

| Indicators | Level | % chg 1 week | % chg since Jan. 1 |
|---|---|---|---|
| Ruble/$ (MICEX) UTS | 29.3897 | -0.04 | 4.35 |
| Monetary Base* | R649.5 bln | 0.48 | 34.58 |
| CPI | NA | 0 | 13.2 |
| International Reserves* | $37.8 bln | 1.89 | 33.57 |
| RTS Index (end of week) | 180.25 | -1.86 | 26.68 |
| Refinancing rate | 25 | 0 | 0 |

*For week prior

**Economic Developments**

Official data published by Goskomstat, indicates that the GDP rose by 5% during the first half of 2001 less than the 5.4% preliminary estimate of the Ministry of Economy. This might put a further dent in official forecasts for full year 2001 growth of 5.5% which will also be impacted by lower oil prices and a weakening external environment. Nevertheless, last week Minister Kudrin reiterated the GOR’s forecast.

During the speech in Duma, Finance Minister Aleksey Kudrin clarified the amount of Russia's total external debt. As of January 1, 2001, total state external debt was $143.3 billion. Of this amount, $93.3 billion is former USSR debt. Paris Club debt totaled $39 billion as of the beginning of the year.

According to Minister of Economy Gref, total investment in the Russian economy increased by 8% during the first eight months of 2001. Both domestic and foreign investment experienced growth, and investment was directed into new sectors, specifically food and light industry. This indicates that investment is holding up well which portends continued increases in productivity growth.

In the forecast report of the Ministry of Economy, presented to the government last week, it is estimated that exports would increase to up to $107 billion this year and be $97-109.9 billion in 2002); foreign direct investment would total $5 billion and $5.5-6 billion in 2002); the unemployment rate would be 1.5% and 1.7% in 2002); and the monthly subsistence level would be R1490/month increasing to R1695 in 2002. Of these numbers perhaps the most interesting is the paltry growth in foreign investment for 2002 which does not show great confidence in the reform program's ability to improve the perceived investment climate.

**Budget**

The budget passed in the 1st reading on September 28th. The compromise agreed increased revenues by R127 billion of with 23 will go to the pension fund and the remainder split R52 billion each between debt repayment (either buybacks or out-year obligations). The deal assumes an oil price higher than the current one but has ample margin for error given the large projected surplus and large anticipated fiscal reserves carrying forward from 2001. Below are our revised charts.

| **Assumptions** | **2002 Budget (1st reading)** | **2002 Budget (draft)** | **2001 projected actual (Min Fin)** | **2001 Budget** |
|---|---|---|---|---|
| Real GDP Growth | 4.3% | 4.3% | 5.5% | 4.0% |
| Avg Exchange rate (R/$) | 31.5 | 31.5 | | 30 |
| Inflation | 12% | 10-13(11)% | 18 | 12% |
| Oil (Urals $/barrel) | 22.0 | 22 | | 18 |
| GDP (R Bil) | 10950.0 | 10600 | 9510 | 7750 |
| **Estimates** | | | | |
| Expenditures* | 1947.4 | 1871.9 | 1379.9 | 1193.5 |
| Interest | 289.7 | 289.7 | 270.3 | 239.8 |
| External | 231.8 | 231.8 | 215.1 | 183.2 |
| Domestic | 57.9 | 57.9 | 55.2 | 56.6 |
| Non-interest | 1657.7 | 1582.2 | 1109.6 | 953.7 |
| Revenues* | 2125.7 | 1998.4 | 1543.5 | 1193.5 |
| Primary Surplus | 468.0 | 416.2 | | 239.8 |
| Overall surplus | 178.3 | 126.5 | 163.6 | 0 |
| External Debt repayment ($) | 14.1 | 14.1 | | 10.5B |
| Interest | 7.4 | 7.4 | | 6B |
| Principal | 6.7 | 6.7 | | 4.5B |
| **% of GDP** | | | | |
| Revenues* | 19.4% | 18.9% | 16.2% | 15.4% |
| Expenditures* | 17.8% | 17.7% | 14.5% | 15.4% |
| non-interest | 15.1% | 14.9% | 11.7% | 12.3% |
| interest | 2.6% | 2.8% | 2.8% | 2.8% |
| Overall Surplus | 1.6% | 1.2% | 1.7% | 0.0% |
| Primary Surplus | 4.3% | 3.9% | 0.0% | 3.1% |

*In 2002 the unified social tax will begin collecting pension fund taxes directly through the tax system. Revenues and expenditures are thus both inflated by R281 billion vs comparable 2001 numbers. If the pension funds are excluded to make the numbers comparable to 2001, total revenues are 16.8% of GDP and expenditures are 15.2% of GDP.

| Foreign Debt Financing | 2002 Budget (1st reading) | 2002 Budget (draft) |
|---|---|---|
| | **$ bil** | **$ bil** |
| Surplus | 5.66 | 4.02 |
| IMF ($ bil) | 0 | 0 |
| WB ($ bil) | 0.04 | 0.04 |
| Japanese WB co-fin | 0.15 | 0.15 |
| Privatization (R bil) | 1.11 | 1.11 |
| Net domestic borrowing | 0.03 | 0.03 |
| Tied credits | 0.685 | 0.685 |
| Gold sales | 0.4 | 0.4 |
| Total | 7.68 | 6.03 |
| | | |
| Total external principal due | 6.70 | 6.70 |
| Diff financing vs princal due | 0.98 | -0.67 |
| | | |
| Total external debt service | 14.06 | 14.06 |

**Banking sector**

The joint strategy of the CBR and the GOR on the development of Russia's banking sector was approved at the cabinet meeting on September 27 "in principle". This means that the document is still subject to substantial editing. Changes must be completed within four weeks by the main drafter, the CBR, together with three ministries: MEDT, Minfin and the Ministry of Antimonopoly Policy. Reportedly, Prime Minister Kasyanov was dissatisfied by the document presented to the cabinet. The GOR resolution issued following the discussion requires, among other things, that a procedure and the deadline be determined for increasing the capital adequacy norm as well as raising the minimal capital requirement. These were major issues of discussion in the lead-up to the meeting but were not adressed in the final document. Duma Banking Committee Chairman Alexander Shokhin openly called the joint strategy "a detrimental document" because it contains no intelligible targets, mechanisms or deadlines, just general declarations.

The approved document is a short run strategy designed for about five years and oriented towards achieving the following reference targets: ratio of banking sector assets to GDP 45-50%, ratio of banking capital to GDP 5-6%, ratio of the credits to real economy to GDP 15-16%. There is little new in the version of the document that has been presented to the cabinet compared with the one that had been discussed earlier in the press and in our weekly. The current version suggests that credit bureaus, still non-existent in Russia, need to be instituted. It also suggests amending the Civil Code to allow a depositor to withdraw funds before a CD matures, but only subject to a 30-days advance notification. The cabinet meeting decided that deposit insurance system would be discussed as a separate document after the joint strategy is finalized.

CBR Deputy Chairman Tatyana Paramonova gave a lengthy interview following the cabinet meeting. She commented that Russia's banking system would be oriented towards the European Union (versus the U.S.). The strategy stipulates that Russian banking system would switch to international accounting standards (IAS) beginning January 1, 2004. This is a daunting task, according to Paramonova, which entails amending legislation and reforming supervision and audit systems. CBR is implementing a pilot project on IAS introduction, but so far only for 8 banks so far. Paramonova welcomed "pure foreign capital" coming to the Russian banking sector. She said this would bring high quality financial services, technologies and business culture to the Russian market. According to Paramonova, the CBR is not going to restrict access to the Russian market for foreign banks provided they are "well-reputed." She stressed that broader presence of foreign banks would stimulate competition in the Russia's banking sector. Paramonova reassured that the GOR would not seek to increase its participation in the banking sector capital. Although the joint strategy says that "in the next few years the GOR will have to maintain its weighty share in the capital of Russian banks," Paramonova said the appropriateness of the state participation in the capital of commercial banks would be reconsidered in the near future. She pointed that assets of most banks with state participation include state-owned property and equipment, so the state might exit bank capital through public sales of state-owned property.

Alexander Mamut, the main proponent of more radical banking reform and in particular of setting high minimal capital requirements, has been fired from the MDM Bank Board of Directors Chairman post. There are rumors in the banking circles that Andrey Melnichenko who owns more than 75% of the bank fired Mamut because the latter's criticism of the CBR's policy hindered MDM's business.

The GOR decided to eliminate limitations on issuance of CBR zero-coupon bonds (beaver bonds), Deputy Prime Minister Alexey Kudrin announced. The GOR approved respective amendments to the laws on the CBR and on the securities market which eliminate temporary limitations for the beaver bonds issuance set in budget law.

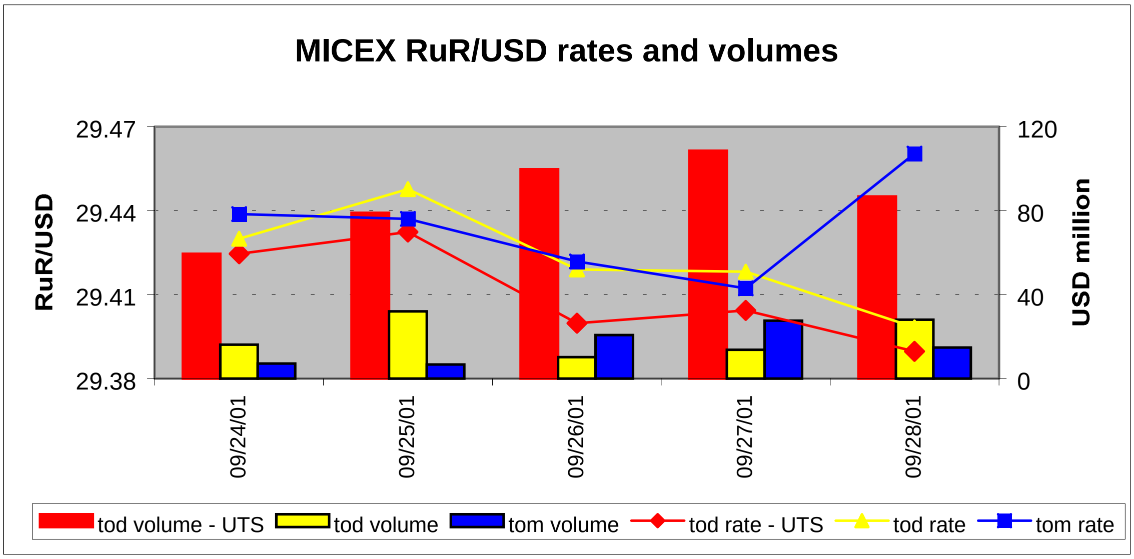
Effective October 1, Russian citizens are allowed to open non-business accounts in banks of OECD and FATF member countries subject to notification of the CBR and tax authorities.

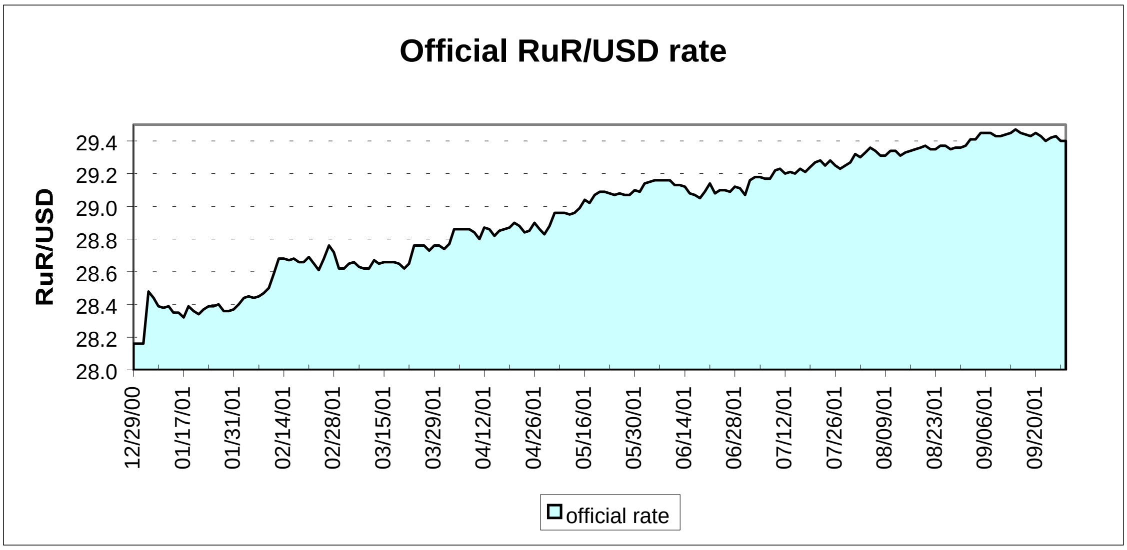
## Financial markets

### Forex Market

The currency market was quiet and stable in the last week of the month and Q3. Abundant supply of dollars sustained by exporters, and high interbank ruble loan rates (even on the days when CBR correspondent accounts balances went up) resulted in ruble firming against the dollar for the week and for the whole month of September. This despite the shocks of the U.S. attacks which briefly sent Russians running for the "safe haven" of the ruble. In the last MICEX trading session of the month "tom" dollar rate went up by 0.16%.

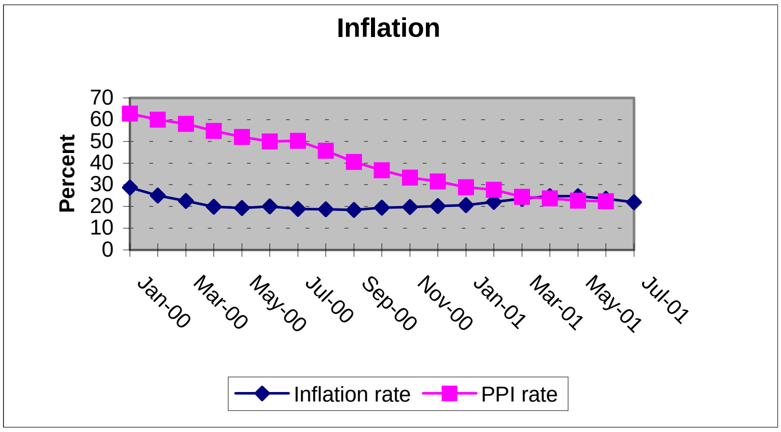
For the week, the ruble firmed 0.04%, closing in the UTS on Friday at 29.3897/$. MICEX weekly trade volumes were $433.59 million, $100.19 million and $77.06 million for the morning (UTS), afternoon "tod" and "tom" sessions, respectively.

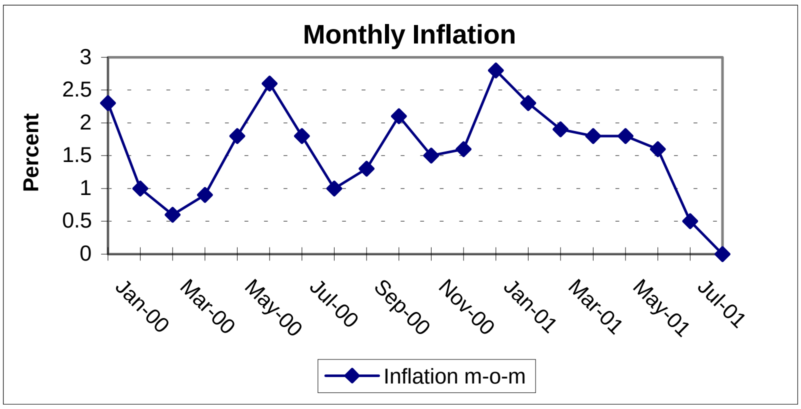



<u>Prices</u>

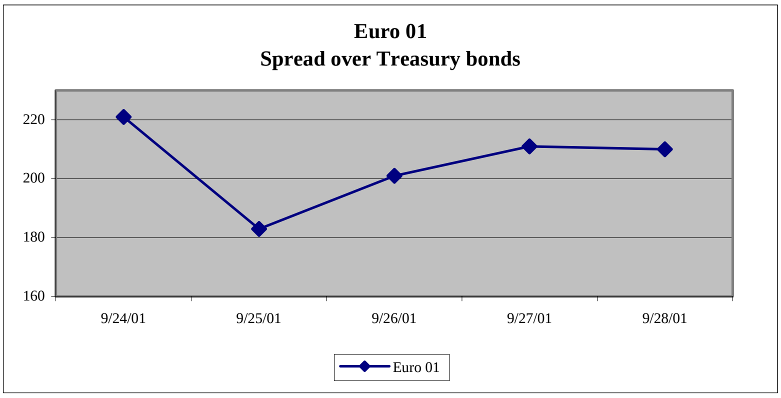
No published data.

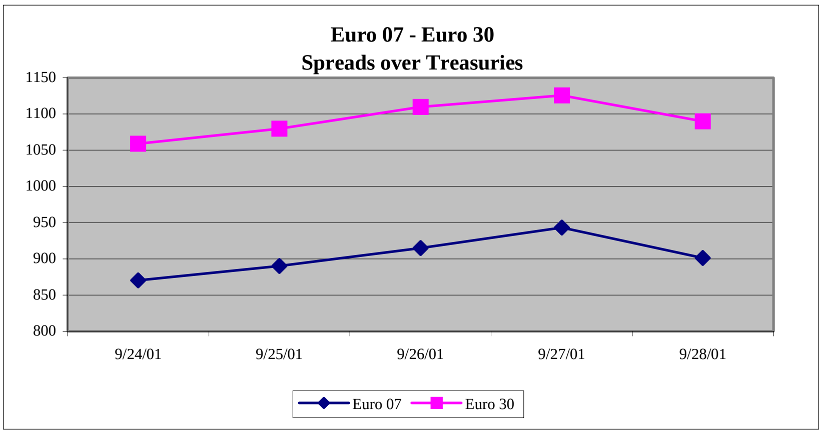



Eurobonds

Prices of almost all Russian Eurobonds issues weakened during the first four days of the week. Russian investors were the most active market participants early in the week. On Friday, the downward trend broke and Russian segment of the bond market was slightly up on the more or less positive political news from the U.S. and upswing in world oil prices.



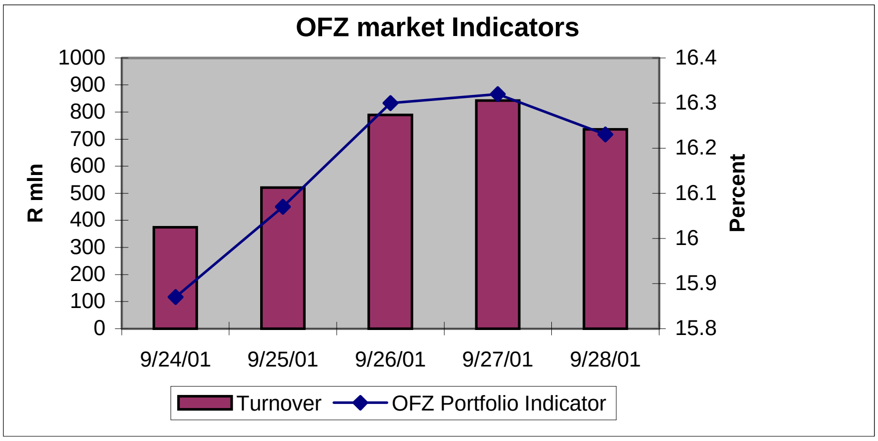



## Interest/Bond Market

*Bonds/Bills*

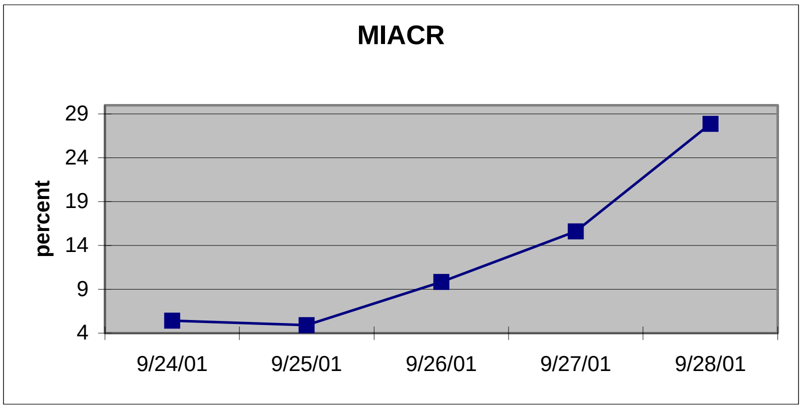
Prices dropped during the first four days of last week on the secondary OFZ/GKO market. Market players preferred to invest in corporate bonds that have a 3-5% premium. The OFZ market, on the contrary, has had a negative real yield due to sell-offs during the recent period of market uncertainty. However, trading volumes increased compared to the previous weeks' levels.

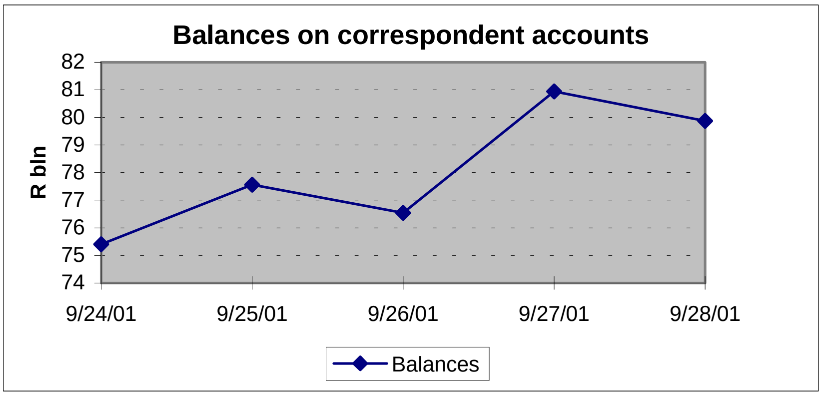
The Finance Ministry reversed its position on a previous announcement on September 17 that it would issue 3-4 year OFZ paper in October 2001. We now understand that it has canceled this placement, but will proceed with a 6-month GKO issue.




*Overnight rates*

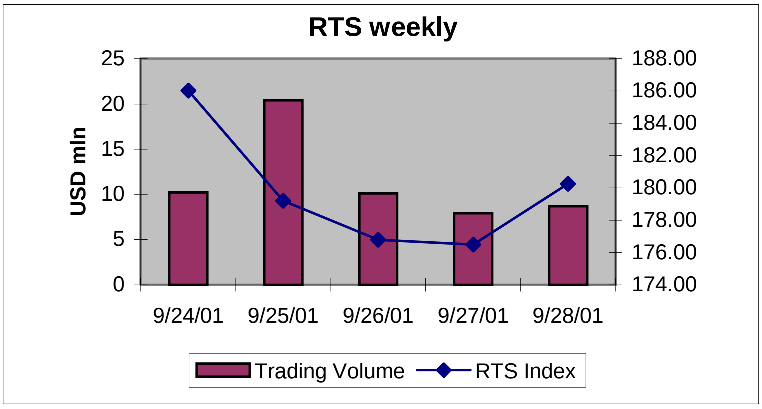
Banks experienced a ruble shortage last week due to the end-of-month and end-of-quarter obligatory payments to the budget. Balances on the banks' correspondent accounts at the CBR dropped compared to the previous week levels - the average daily balances were R78.1 billion, while the short-term ruble interbank loan rates soared up to 28% p.a. (MIACR) during the last day of the month.

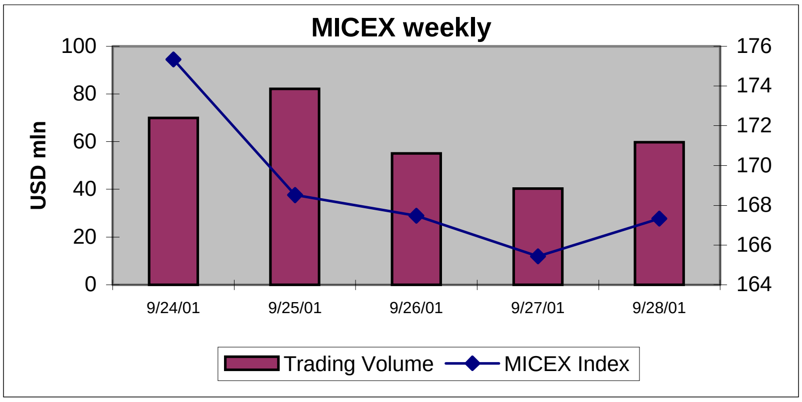


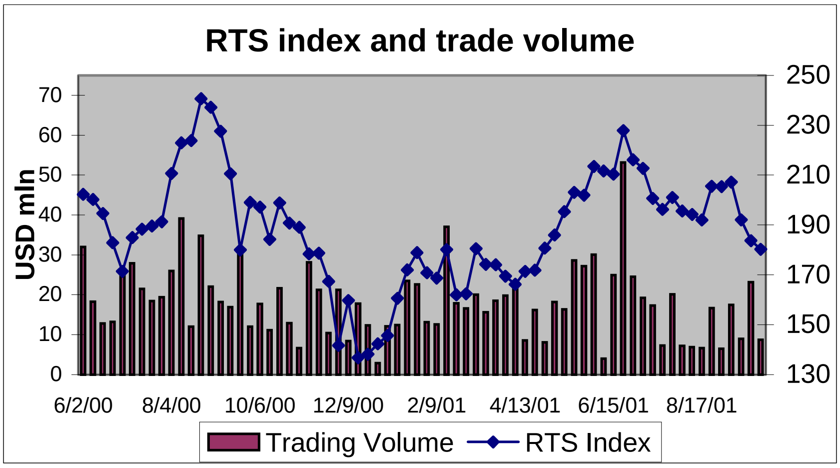




## Stock Market

The Russian stock market was down again last week. The activity of the market players decreased even further with the average daily volumes dropping to $11.5 million. The market was highly volatile, especially in the oil sector, due to the instability in world oil markets. LUKoil, Surgutneftegaz and Tatneft, traditionally stable on the market, were the main losers for the week. "Energos", on the contrary, were up last week, especially RAO UES and Mosenergo (+4% and 5.3% respectfully), where a corporate conflict was resolved. The RTS index pierced the 180 level and finished the week down by 1.86% in dollar terms.



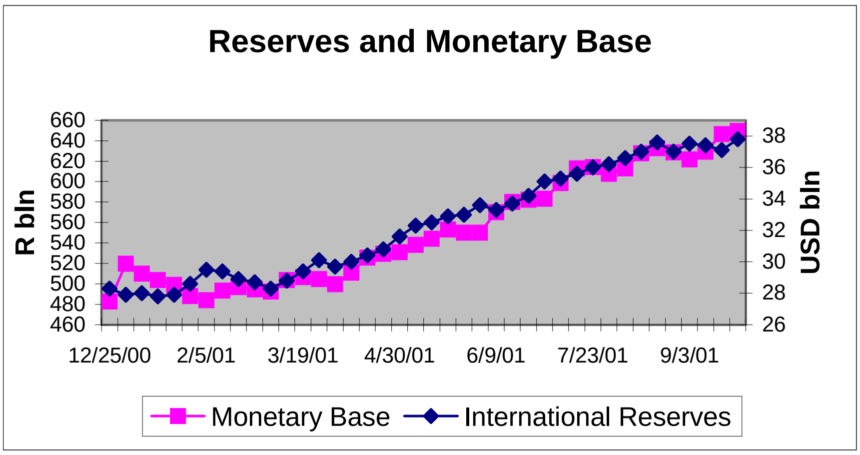



<u>International Reserves and Monetary Base</u>

International reserves of the Finance Ministry and Central Bank jumped by $700 million last week and totaled $37.8 billion - a new post-Soviet era record high. This covered the past two-weeks' $400 million fall.

The monetary base increased at a slower pace last week and it totaled R649.6 billion - R3.1 billion higher than the week before.



## Civil Service Reform

In the prior focus on salaries in Russia, we noted the serious challenge that low public sector wages presented for reforming the Russia's civil service in a way that reduces corruption, improves productivity and attracts an adequate level of talent. This week we look at specifically at the issue of civil service reform and what the GOR may be planning to do about it. We will look primarily at reform on the federal level although creating incentives for reform on the regional and local levels clearly has to be a key objective of any civil service program.

### The current situation - dead wood

Russia has a serious problem with the kind of people currently in government. While at the very top of several ministries there is a young, highly competent, over-worked cadre of reformers, for the most part the federal bureaucrat has done little but age over the last 10 years. Currently the median mid-level federal functionary is over 50 and has spent most of his or her career serving the Soviet state. When these people started their careers their pay was on par with industry and often enjoyed better benefits. Since 1990, however they have seen their relative salaries drop to less than 50% of equivalent jobs in the private sector. The result has been a serious adverse selection problem: those that the government would want to keep have for the most part left; only those who either could not find a job in the private sector or through corruption can keep their salary at an attractive level, generally have stayed.

On the one hand this sorry state of affairs makes reform difficult. Many of these workers even if motivated with things like higher salaries, more clear accountability, merit pay and training are unlikely to significantly change their behavior. On the other hand, however, the average age of the civil service presents an opportunity: an older work force can be lured out of the system more easily with early retirement schemes or to some extent can simply be waited out.

### Big savings or big cost?

There are two common misconceptions about the Russian civil service that have major implications for reform:

1) Russia has a bloated bureaucracy that must be drastically cut. In fact, Russia has far fewer civilian government employees per capita than most industrialized countries. Total civilian employment in Russia is about 9% of total employment vs. 21% in the U.S. and 13% in Germany. (Emerging and transition economies are more in line with Russia's level.) And while the absolute level of civilian employment has risen somewhat from 1 million to about 1.1 million, this has all been on the regional level; federal employment has stayed roughly the same at 400,000. While the comparative country data can be a bit deceptive depending on how countries classify workers in major areas such as health and education, the implication here is clear. While Russia has a lot of non-productive civil servants, the challenge is to make them productive, not simply to get rid of them. This

means that a simple equation where-by the cost of higher salaries is compensated by cuts in the work-force may not always be appropriate.

2) Payroll is a major cost item that would balloon if the GOR were to raise salaries significantly. In fact payroll, together with indirect costs of federal employees, represents only about 2% of the budget. While this is not insignificant, there is certainly room for salary increases even without significant cuts in the number of personnel. The key is make the salary increases productive, ie. they should not go to those whose productivity won't change and they should be combined with process reforms that support productivity improvements. Of course all of this is easier said than done.

## **Attracting talent – for the right reasons**

Surveys of young people joining government show that the primary motivation for joining the federal government is either to spend 2-3 years "getting connections" or else to exploit corruption opportunities. This means that while the government may be attracting "talented" recruits, they may not be directing their skills in the optimal direction.

Surveys of senior officials put more competitive salaries at the top of the list of measures needed to hire and retain qualified staff. They also say that fringe benefits (cars, cheap holidays, insurance) are less and less of an attraction as benefits in the private sector proliferate. There is a particular problem with the current inability to provide salary adjustment for specialist jobs such as in IT. Ministries have often had to resort to off-budget financing schemes to retain key personnel. But money is not the only issue. Morale among more talented workers is low because they work in a system that does not reward competence or honesty. Even at higher salaries, more talented workers resent working with incompetent staff who make the same or more than they do, particularly if it is through corruption or because they have better to access benefits.

## **Fighting corruption**

A consistent point one hears from those working on civil service reform is that, while stopping corruption is a central goal of reform, there are very few ways to target it directly. After many failed anti-corruption drives, there is general frustration with attempts to legislate morality or to enforce blanket anti-corruption rules without attempting to get at its root causes. For those who have lived and worked in the Soviet and the Russian systems, there are no magic bullets.

Clearly a reasonably competitive salary is a prerequisite for slowing corruption, as it is for attracting talent and motivating productivity. But process reforms can have an equal if not greater effect. Part of what plagues the Russian bureaucracy is that clear lines of responsibility and authority more often than not do not exist. This is partly a legacy of the Soviet system when party and governmental bodies had overlapping jurisdictions. This means that bureaucrats can't be held accountable for outcomes which in turn gives them discretion on whether and how they do their job. This creates a fertile field for corruption. Changing processes to centralize decision-making where possible, simplify lines of responsibility and eliminate overlapping jurisdictions, and set out performance standards that can be measured and enforced even at the highest levels are all steps that can reduce the scope for corruption.

**The GOR's program**

The GOR came out with a preliminary concept paper on civil service reform this spring. As an indication of how controversial this topic is, the paper has not been widely distributed. Nevertheless we are told that is contained few specifics. A finalized government strategy paper we are told could be ready by January. There appears to be some debate about the appropriate level of detail of the government's strategy and any legislation that follows. Past attempts to prepare detailed versions of a civil service code have met stiff resistance from interest groups. The other problem is that designers of civil service reform still don't know what works in Russia. International experience on things like merit pay is ambiguous at best and other concepts have yet to be tested.

What looks likely is that the initial step in 2002 only will be to set overall goals and standards. Initiatives such as tax administration reform, which has already set up pilot projects and designed a fairly specific reform program, would be allowed to proceed. Other agencies would be allowed to run their own pilots. Regional initiatives, ideally would also be incubators of new ideas. Unfortunately, there is no real mechanism in place for sharing information. Progress on civil service thus looks likely to be spotty and gradual, not ideal, but perhaps as much as can be expected.

Questions or Comments?

Please send your questions or comments on this Weekly to "ustreasu@online.ru".

EXPLANATORY NOTES

1. **EXCHANGE RATES**: SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). "$-tod" price is the price of the dollar with same day delivery. "$-tom" is the price of the dollar with delivery on the next day. Minimum lot size for each of the dollar instruments is $100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

2. **INTEREST RATES**: Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

**3. STOCK INDICES**: The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

**4. INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION** represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities, repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

**5. MONETARY BASE** (M1) is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

**6**. **LOMBARD CREDITS**, distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.